CSR and Corporate Law: The Case for Preferring Procedural Rules

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Abstract

Every conception of the Corporate Social Responsibility and of the optimal relationship between the interests of the shareholders and those of the other stakeholders implies and suggests a specific solution to the problem of limiting and controlling the discretionary power of managers. Stemming from this premise, the paper critically analyses three conceptions of CSR – the theory of the shareholder value, the long-term coincidence approach and the team production theory. We interpret these theories as three different conceptions of the relationship between the interests of shareholders and other stakeholders, and we evaluate them in terms of the model of corporate governance that they propose and in terms of their ability to reach the equilibrium of the interests of shareholders and stakeholders that they describe as optimal.

We conclude that none of the three theories accomplishes its goal, and more precisely none of them is able to provide manageable criteria to control the discretionary power of managers. We maintain that in contexts where there is great difficulty in defining the criteria to guide the managers' decisions, it is better to shift the attention from the substance to the procedure, and we propose two rules of best practice that in our view could improve the quality of managerial decisions in CSR matters.

CSR and corporate law: the case for preferring procedural rules (**).

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1. CSR AND CORPORATE LAW.

CSR scholarship is becoming increasingly diverse (1), and a universally agreed upon definition of CSR is difficult to formulate. However, almost everyone would agree that CSR is focused on the notion that "the legitimate concerns of a corporation should include such broader objectives as sustainable growth, equitable employment practices, and long-term social and environmental well-being" (2). The CSR debate is evidently intertwined with the debate on the proper objectives of the corporation and especially with the traditional and well-known problem of the relationships between the interests of stockholders on one hand and the interests of other stakeholders -defined as all affecters and affected by corporate policies and activities-, on the other.

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(1) See D Gordon Smith, "The Dystopian Potential of Corporate Law", University of Wisconsin Law School and Social Science Research Network, <http://ssrn.com/abstract=976742>.

(2) John M Conley & Cynthia A Williams, "Engage, Embed, And Embellish: Theory Versus Practice In The Corporate Social Responsibility Movement" (2005) 31 J. Corp. L. 1-2. See another definition in Lorenzo Sacconi, "A Social Contract Account for CSR as Extended Model of Corporate Governance (Part I): Rational Bargaining and Justification", Università di Trento – Dipartimento di Economia, Discussion Paper No. 10, 2004, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=731647> and (2006) Journal of Business Ethics 259: "Corporate Social Responsibility is a model of extended corporate governance whereby that runs a firm (entrepreneurs, directors, and managers) have responsibilities that range from fulfilment of their fiduciary duties towards the owners to fulfilment of analogous fiduciary duties towards all the firm's stakeholders". By the same author see also "Corporate Social Responsibility (CSR) as a model of 'extended' corporate governance. An explanation based on the economic theories of social contract, reputation and reciprocal conformism", Liuc Papers No. 142, February 2004, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=514522>.
For a discussion of the definitions of CSR see Michael Hopkins, *Corporate Social Responsibility & International Development. Is Business the Solution?* (Earthscan, London, 2007) 15.

Given the obvious duty of directors and managers ([3]) (and of all corporate bodies) to comply with the law, the different conceptions may be distinguished, from a corporate law perspective, according to the way in which each of them solves the problem of defining the limits of the discretionary power of managers. More explicitly, nobody can doubt that the managers (and all corporate bodies) have to comply with the rules of corporate law or of other laws that protect the interests of creditors, employees or stakeholders other than the shareholders. The problem therefore arises when we shift from considering management choices that are more or less constrained by law to considering choices that call for the exercise of a more or less wide discretionary power of managers.

Here the exact identification of the beneficiaries of their fiduciary duties as well as the precise definition of the interests whose care and protection shall head and inspire their choices becomes paramount. In a nutshell, the question is: who's interests the corporate managers (and all the other corporate bodies, included the shareholders' meetings) ought to pursue? Only and exclusively the common interests of all stockholders, or are they allowed, or obliged, to give weight to interests of other stakeholders, or eventually are they obliged to pursue the interest of not just a single person but the interest of the "firm as such" *(unternehmen an sich*), conceived of as an institution?

The links between the CSR and the problem of exactly defining the interests whose satisfaction corporate managers shall pursue, are therefore evident. At

([3]) The meaning of the term "manager" may not be entirely clear, as the power to manage the company is differently distributed among corporate bodies in the different legal systems. In this paper, the focus is on the management function in itself, regardless of the corporate body who is in charge of managing the company in any particular system of rules. Therefore, the term "manager" for our purposes is referred to any person who has the power to take discretional decisions able to affect the company's conduct and its results; this term can therefore refer, as the case may be, either to "executives" or even to non-executive members of the board of directors, where they are entrusted with the power to participate in strategic decisions (e.g. the power to approve strategic plans). More precisely, for the purposes of our discussion we do not think it would be meaningful to distinguish between executives and non-executives, since we do not believe that non-executives can be said to act on behalf of interests substantially different from those represented by executives – it is rather a question of different attributions, but for the pursuit of the same interest.

the end of the day every conception of the CSR and of the optimal relationship between the interests of the shareholders and those of the other stakeholders implies and suggests a specific solution to the problem of limiting and controlling the discretionary power of managers (which is also the central argument of every corporate governance debate).

Obviously, it could be the case that the problem is solved directly by law. This is the case where a specific rule indicates the interests that managers (and other corporate bodies) must consider in taking their decisions regarding the conduct of the corporate business and possibly establishes the way in which those interests shall be "balanced" in case of apparent conflict amongst them. Unfortunately, this seems to be a very rare case. In a few of the most important systems the interpreter of the law can find some cues, often of uncertain significance. In many of them the law gives no useful indication ([4]).

In this paper we examine three different conceptions of CSR. These three theories can be interpreted as different description of what is well established by a given law or as proposals of interpreting (or, where necessary, of

([4]) See for example the UK Companies Act of 2006, which is often cited as the most advanced European legislation from the perspective of CSR. Article 172(1) ("Duty to promote the success of the company") provides as follows: *"A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole, and in doing so have regard (amongst other matters) to – (a) the likely consequences of any decision in the long term, (b) the interests of the company's employees, (c) the need to foster the company's business relationships with suppliers, customers and others, (d) the impact of the company's operations on the community and the environment, (e) the desirability of the company maintaining a reputation for high standards of business conduct, and (f) the need to act fairly as between members of the company".* The rule, however, is somehow ambiguous. First, it is not clear what the obligation to *"have regard"* exactly means. Can this be read as allowing, or even mandating directors to balance the shareholders benefit against the interests of other stakeholders and eventually to decide to prefer the latter? Or does it simply mean that, provided that the benefit of the company's members is maximised, directors have to take account of other interests in choosing a particular course of action among those that are equally possible? The second and narrower reading seems confirmed by paragraph (2), which provides that *"where or to the extent that the purposes of the company consist or include purposes other than the benefit of its members, subsection (1) has the effect as if the reference to promoting the success of the company for the benefit of its members were to achieving those purposes"* – thus apparently including the interests of the stakeholders inside the corporate interest only when the purposes other than the benefit of company's members are included in the purposes of the company (as a result of a choice of the shareholders in this sense, it would seem).

amending) the law in the way suggested by each of them. When interpreted in the first sense, each theory can be evaluated only within the given system of rules whose content it claims to describe at the best. This is not the viewpoint we will assume in this paper. We shall consider instead the three theories as suggestions of alternative possible conceptions of CSR that the interpreter of the law, when possible, or the legislator, when necessary, should endorse in order to build a system of rules capable of giving the best practical content to CSR requirements.

Therefore we shall evaluate the three theories according, firstly of all, to their ability to provide a coherent and empirically realistic description of the relationships which in fact occur between the interests of each stakeholder. We will then evaluate their ability to build a model of corporate governance, i. e. to create within the corporation a system of powers, incentives and controls, coherent with the goal that each theory declares to pursue. In other words, we will endeavour to establish whether the system of governance proposed by each theory seems in fact able to obtain the specific way of coordinating the interests of different groups of stakeholders, that the corresponding theory suggests as the optimal.

In this perspective, as we shall see, the central problem becomes that of defining the legal means able to constrain the discretionary powers of the managers and of the other corporate bodies (the board of directors, the shareholders, and so forth). Here again the problem of the possible differences amongst the different systems, and amongst the different models of corporate governance in each system established by the law, may become relevant. It is of course possible that the model suggested by a given conception of the CSR is - or might be made - compatible with the existing law in a system (for example in the USA corporations, usually lacking a controlling shareholder) but not in an other one (for example in the systems in which the presence of a controlling shareholder, or of a coalition of shareholders, is widespread). We cannot examine in detail all existing and possible systems and therefore we admit that our evaluations might appear convincing where referred to a given system (if

any) but not as general conclusions. However, we are confident that the problem we consider paramount (the possibility of limiting the discretionary power of managers) presents itself in similar terms in every law system. As we shall see, the difficulties in limiting this power that we will consider as determinant are of a conceptual nature not particularly linked with one or another specific rule. Their roots lie in the nature of the power and in the limits of any conceivable control of its use by the judiciary. In this sense our conclusions aim to have, at least potentially, a general scope.

2. Some preliminary notes.

From the point of view of the relationships between the shareholders' interest and the interests of other constituencies, a preliminary distinction must be taken into account. It is the distinction between the theories admitting that the interests of the shareholders can be subordinated to the interest of somebody else (in this case this interest is usually identified not with the interest of any group of actual persons but with the "superior " of some mystic body, like the firm, the people, etc.) and theories in which this possibility is denied. The latter can be in turn distinguished taking into account the different ways each conceives of the interest of the shareholders and of how they can be coordinated with the interests of the other stakeholders.

All the three conceptions examined in this paper belong to the second group of the possible conceptions of the interest that the companies should pursue. All share the belief that the shareholder interest cannot be simply postponed to other interests and explore different ways of accommodating the possible conflict between the interest of shareholder and that of other stakeholders. This is true even for the theories that recommend a higher level of stakeholder protection ([5]).

([5]) We maintain that these modern theories about stakeholders protection and CSR are framed in theoretical context far from the one in which the old institutional conception was once accrued. If we assume that what distinguishes an institution from a community is the presence in an institution of a shared purpose that is missing

Another preliminary note: in this paper we shall consider only public companies, meaning companies (or corporations, in the US context) whose shares are listed in capital markets; most of the problems and discussions that follow would have a different shape in the context of close companies.

In order to prevent the ambiguities stemming from the use (very widespread in the debates on CSR!) of concepts void of content or, at least, of any apparent practical usefulness, we endeavour to better clarify our reasoning by checking its implications in relation to a set of facts we extracted from the case decided by the Illinois Appellate Court in the famous case *Shlensky v Wrigley* ([6]). In that case the contested business decision was that of installing lights in a baseball stadium. The plaintiff observed that the company suffered in the last years heavy operating loss from direct baseball operations due to inadequate attendance at games, and he concluded that if the directors continued to refuse to install lights and schedule night baseball games, the company would continue to sustain comparable losses. The defendant refused to install the lights because he was of the opinion that baseball is a daytime sport and that the installation of lights and night baseball games would have a deteriorating effect upon the surrounding neighbourhood. We assume for the sake of the argument that the plaintiff was right in asserting that the installation of the night lights was in the immediate financial interest of the shareholders.

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in a community, then the latest theories regarding the protection of Stakeholders and CSR cannot be classified as institutional.

These recent theories do not seem to be inspired by the idea that a common goal exists (e.g. to navigate boats on the Rhine) and all stakeholders would be required to collaborate in order to fulfil achievement. They do not even seem to believe that a higher interest exists (that of the *"unternhemen an sich"*, so to say the interest of the business as such) to which all particular interests must bend. It would seem rather that these theories move from the simple idea that different groups exist (different Stakeholders) who have different interests but must live and possibly work together. This is not a collaboration in view of pursuing all together one defined "Great End" to which all individual interests must be sacrificed. It is instead the collaboration that may be - from time to time - organised to one's own advantage by parties whose actions and welfare are interwoven and influence each other. However, as we shall see, they deeply differ just in the conception of what should be considered as the real interest of the shareholders and not only in the judgement about the best way of coordinating the interests of the shareholders with those of all other stakeholders.

([6]) 95 Ill. App. 2d 173, 237 N.E. 2d 776 (1968).

Therefore, we assume the existence of a possible conflict between the immediate financial interest of the shareholders and the interest of the "neighbourhood".

3. THE INTERESTS OF SHAREHOLDERS AND THREE CONCEPTIONS OF ITS RELATIONSHIP WITH THE INTERESTS OF THE OTHER STAKEHOLDERS.

As anticipated, in this paper we shall examine three different conceptions of the possible relationships between the interests of the shareholders and the interests of the other stakeholders.

In order to properly understand the content and implications of each one, and the differences amongst them, it is necessary to better clarify the notion of shareholder interest and the way in which this notion is interpreted by the supporters of each of the three theories. So we will now briefly sketch the essential contents of each of them, and immediately after we will discuss the problem of exactly identifying the shareholder interest.

According to one conception, widespread among corporate law students, the only or in any case the principal duty of management is to maximize **shareholder value,** which implies that the interests of the shareholders must be considered first and foremost in every business decision ([7]). In this perspective CSR problems must be tackled on a different level. In brief, the conviction that inspires the supporters of the shareholders value theory is that imposing social responsibility on firms is a goal that can be better achieved through obligations imposed on the firm from the outside -especially by

([7]) The literature following the shareholder value paradigm is vast; a seminal work is the one by Frank H Easterbrook and Daniel R Fischel, *The Economic Structure* of *Corporate Law* (Harvard University Press, Cambridge, Mass., 1991); see also Stephen M Bainbridge, "In Defense of the Shareholder Wealth Maximization Norm: A Reply to Professor Green", 50 Wash. & Lee L. Rev. 1423 (1993). For a critical review of the shareholders primacy norm see D Gordon Smith, "The Shareholder Primacy Norm", 23 J. Corp. L. 277 (1998). For recent contributions to the debate see D Gordon Smith (n 1); Kent Greenfield, "Saving the World With Corporate Law?", 2007, <http://ssrn.com/abstract=978242>.

precise rules established by law- rather than by a reformulation of the key criteria that should guide the managers' discretional action. The supporters of this thesis admit that conflicts may arise between the interests of the shareholders and the interests of other stakeholders, but they believe that the task of indicating how those conflicts shall be solved is for the law rather than for managers. In short: it is a matter of intervening on constraints rather than on the objective-function.

Another conception of the relationship between shareholder and stakeholder interests, refuses instead the very existence of a conflict. This conception is inspired by the idea that in the **long term** a substantial **coincidence** exists among all involved interests ([8]). Thus, there is no relevant room for real contrasts between the shareholders' interests, - properly screened in the long run - and the interests of other stakeholders. In this view, it is not a problem of choosing which to protect among conflicting interests, but only a matter of improving the comprehension that different groups of stakeholders (and especially the shareholders) have of their own "true" interests. This "cognitive" approach suggests trying to make the members/partners of the common enterprise understand just exactly what their true long term interests really are.

In the third conception that we shall examine here, the public corporation is viewed as the formal organization of a **team** of shareholders, creditors, workers, managers and communities ([9]). The ability of the team to reach optimal **production** levels depends on the cooperation and the willingness to invest by members of all groups. Given that creditors, workers, communities and so on make investments specific to this "team" (investments that are most

([8]) See Lawrence E Mitchell, "The board as a path toward corporate social responsibility", Social Science Reasearch Network, <http://papers.ssrn.com/abstract_id=266622>.

([9]) See Margaret M Blair, Lynn A Stout, "A Team Production Theory of Corporate Law", 85 *Va. L. Rev.* 247 (1999); Id, "Director Accountability and the Mediating Role of the Corporate Board", Social Science Research Network, <http://ssrn.com/abstract=996683>. For a social contract approach on the theory of corporate governance see also Lorenzo Sacconi (n 2) and, by the same author, *The Social Contract of the Firm: Economics, Ethics and Organisation* (Springer, Berlin, 2000).

productive when employed in connection with the specific corporate enterprise) all face the risk of opportunism and exploitation by shareholders. As a result, they may be reluctant to place their capital under the control of the shareholders, or -what is from this viewpoint practically the same- of managers and managers strictly obligated to pursue only the shareholders' interests. The solution is that of investing managers with the task of resolving the competing claims of all participants in the interest not only of the shareholders, but of the whole team. Managers should be viewed and should view themselves, not as shareholders' agents, but as "mediating hierarchs".

Besides the appearance, the borders of each theory with respect of the others are somewhat confused. For example, the shareholder value theory and the theory of the long-term coincidence might even be interpreted in the sense that the shareholder interest remains still paramount. It would only be a matter of defining exactly what has to be considered as the "true" interest of the shareholders. Where this latter is appropriately defined, the conflict with other interests disappears, and the shareholders' interest may still stand as the guiding light for any and all corporate bodies. The possibility therefore exists that, in spite of sharp differences in language, both logically collapse one into the other, especially where the supporters of the shareholder value specify that the interest they consider is that of the long- term profitability of the firm.

On the other hand, even the borders between the long-term coincidence and the team production may appear confused. In some sense the team production theory may be interpreted as a specification of the theory of the long-term coincidence. The former simply specifies the reason why in the long term the interests of the shareholders are aligned with that of the other stakeholders, all being equally interested in the best functioning of the team.

In our opinion, to better distinguish these different theories, we need to elaborate a more precise conception of the interest of the shareholder. Usually the interest of the shareholder is defined as the interest to maximize the expected profits of the firm.

What must be underlined in this definition is the fact that even if this maximization is projected beyond the short term, what counts in the end is still the **present** value of the expected profits. In order to establish whether a given decision is in the interest of the shareholders so interpreted, one has to verify whether the decision is able to increase the profits that are perceived as expected at the moment in which the decision is made. In this conception of the shareholder interest (that in order to prevent confusions we shall call the "immediate financial interest" of the shareholders), that factors that become determinant are **perception** and **time**. In our view a decision which could be in the long term interest of the shareholders but which is not generally perceived at the moment in which is taken as able to increase the profits of the firm, cannot be considered as a decision in the immediate financial interest of the shareholders.

So we can make a distinction between decisions in the immediate financial interest of the shareholders - which are the decisions that are immediately and generally perceived as possible ways to increase the expected profits of the firm - and decisions which could prove to be in the interest of the shareholders but that are contrary to their immediate financial interest because they are generally perceived as not comprised in the set of choices that are possibly able to increase the future profits of the firm. Obviously the borders between the two sets of decisions are not fixed and depend both on subjective elements, in the sense that the perception may be changed by means of adequate motivations and reflections, and on objective elements, given that the difficulties to perceive the supposed different nature of a decision apparently contrary to the immediate financial interest increase exponentially with the complexity and the uncertainty of the factors on which depend the probabilities that an immediate sacrifice will be compensated by a future gain.

We can finally explain the distinction with reference to the Shlensky v. Wrigley case we decided to use as an explanatory example. According to our vision, in that case installing the lights was the decision in the immediate financial interest of the shareholders. Not installing the lights was a decision contrary to

their immediate financial interest, even if it was possible that the sacrifice made for protecting the supposed interests of the neighbourhood could have been compensated in the future by a corresponding or a superior gain for the firm.

In this vein we propose to interpret the shareholder value as the theory according to which the managers are allowed to take only the decisions which can be in the immediate financial interest of the shareholders. It is true that there are variations of the theory – as the "enlightened shareholders' value" theory advanced by Michael Jensen ([10]) – that consider the maximisation of the value of the firm in a medium-long term perspective as the proper goal of managerial action. Even in this case, however, the immediate financial interest is what counts because the value for shareholders is the actual value of the expected profits of the firm and therefore managers, even though in a long-term perspective, must choose the course of action that maximises the actual value of the firm for shareholders.

The long-term coincidence and the team production theory may be interpreted as the theories according to which the managers are allowed to make decisions in favour of the other stakeholders and contrary to the immediate financial interest of shareholders, on the assumption (taken as a matter of faith by the former and theoretically elaborated by the latter) that this line of conduct may be still in the interest of the shareholders, even if it is not in their immediate financial interest. More precisely, the "long-term coincidence" perspective maintains that in the long term the interests of shareholders and those of the other stakeholders do not stand in conflict but do coincide. In fact, under this theory there is only one and the same interest that is shared amongst all stakeholders of the corporation which coincides with the maximisation of the value of the firm for all stakeholders in a proper long-time perspective.

([10]) Michael C Jensen, "Value Maximization, Stakeholder Theory, and the Corporate Objective Function", Journal of Applied Corporate Finance, Vol. 14, No. 3, Fall 2001, and Social Science Research Network <http://papers.ssrn.com/abstract_id=220671>.

Therefore, every choice between the immediate financial interest of shareholders and the interests of other stakeholders is nonsense, because in the correct time perspective there is no need for a sacrifice of the interest of anybody and the benefit for stakeholders will also inevitably result in a benefit for shareholders.

This is the point of coincidence with the "team production" theory which, in this sense, can be viewed as a more elaborate variation of the long-term coincidence approach. The team production theory in fact essentially tells us that the maximisation of the value of the firm is obtained by an optimal cooperation amongst all those individuals and institutions that invest a stake in the firm itself; this means that any sacrifice of the interests of other stakeholders to the benefit of shareholders does in fact imply a decrease of the aggregate value of the firm because the other stakeholders, when realising the opportunistic behavior of shareholders, shall reduce their investment in the firm to a sub-optimal level thus reducing the aggregate value of the firm for all stakeholders, including shareholders.

3. Critique to the theory of the shareholders' value.

As noted before, each of the theories considered here can be evaluated –given the definition of shareholders' interest that it advances – according to two criteria. First, we can evaluate each theory in terms of its explanatory power and its internal coherence; the questions here are essentially the following: does the theory provide a realistic description of shareholders' interests? And: Is the theory intrinsically coherent? Second, we can ask ourselves if each theory is effective in meeting its goal; assuming that the common aim of all these theories is to provide a criterion to control the discretionary power of managers, does each of them reach this objective? We believe that none of these approaches is completely satisfactory from one or both points of view.

As we saw before, we interpret the theory of the shareholder value in the sense that shareholders are the only addressees with regards to diligence and

protection duties imposed on managers, and consequently in case of conflict with other shareholders' interests, managers have no other choice but to sacrifice the interests of those stakeholders (if we imagine that no such a conflict may exist and that the satisfaction of the long-term interests of the shareholders requires due consideration of the interests of other stakeholder the theory collapses in what we called "long–term" coincidence).

As we have anticipated, the nucleus of this thesis resides in the idea that imposing social responsibility on the firms is a goal that can be better achieved through obligations imposed on the firm from the outside - especially by precise rules established by law - rather than by a reformulation of the key criteria that should guide the managers' discretional action. In this way two benefits could be reached: a level of protection of stakeholders' interests not randomly decided by managers, but defined *ex ante* collectively (in the realm of politics) and a suitable constraint (the criterion of the shareholder value) able to compel the managers towards the sole and proper social goal of the firm, that of making as much profit as possible.

We think that this reasoning - although founded on topics of appreciable strength and realism - is today put in crisis by reasons both theoretical and historical.

The first reason (theoretical) is the acquired - and today very widespread – awareness concerning the structural incompleteness of laws and contracts. There is neither rule nor contractual clause able to adequately govern all the events that could occur in the context of its potential significance. It is true that the judge has the power to complete both rules and contracts, putting them in a position to govern each and every relevant situation. Nevertheless, recognition of this fact far from solving the problem simply puts it in a more complicate context. If we admit that rules are not able to completely constrain in advance the discretion of the managers and that there are a lot of problems

that only the intervention of the courts may solve, the overall sense of resorting to an external constraints systems is radically transformed ([11]).

This kind of system may no longer be conceived of as a rigid imposition concerning external limits - fixed and predetermined - but as a system in which social responsibility depends on more or less elastic margins that the interpretation of laws and contracts shall ensure first of all to the same managers, then to the other parties and eventually to the courts.

The result is that it is far from certain that the law, and more in general all kinds of external constraints, could be capable of guaranteeing in a more simple and sure way the same goals that could be achieved through a change in the definition of the objective-function and of the interests which managers are accountable to.

Instead, a possibility exists that external constraints are, in many situations, unable to impose appropriate behaviour on managers, especially where problems in rapid or surprising evolution are concerned, that the legislature is unable to fully govern with its interventions *ex ante*.

Therefore, it is quite possible that the degree of corporation responsibility that has been identified as optimal is not reachable by purely external constraints. What seemed at first glance a matter of means, appears to be a matter of ends.

Then the two conceptions (shareholder value / protection for all stakeholders) cannot be considered as a two alternatives in which equal fulfilment of social expectations in the results can be granted, and that differ only with regards to the means (external constraints - law, contracts, etc. - or internal constraints - inclusion of social objectives in the goal pursued by the company) used to obtain them. They must be regarded, instead, as two distinct alternatives, each

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([11]) The literature on the incompleteness of contracts in general is huge and well known; for specific reference to the discussion on CSR see Lorenzo Sacconi (n 1); Id., "Incomplete Contracts and Corporate Ethics: A Game Theoretical Model Under Fuzzy Information" (2003), University of Siena Working Paper, Social Science Research Network, <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=402260>; Margaret M Blair, Lynn A Stout (n 7).

of which allows for varying degrees of protection of the stakeholders' interests ([12]).

A second issue relates to the effective existence of the merits given to the view that the managers – having fully complied with laws - must focus solely on maximising the value for the shareholders. It is more than doubtful that this has actually the ability to provide precise and unique parameters of evaluation with regards to the behaviour of the managers, which is indicated as its supreme honour.

In fact, shareholders have different interests, views and expectations, which makes it problematic to identify their common interest; unless the shareholder is transformed - as does the shareholder value theory - into an economic abstract, identified, not with shareholders in flesh and bones, but with a certain type of ideal investor (who at all times controls all existing companies and decides which one to exit, which one to enter, which one to ignore, etc.) ([13]).

If one refuses this approach, one realises immediately that the maximisation value parameter does not provide as unique guidelines as supporters seem to believe. Very often, managers find themselves forced to balance the interests of the different categories of investors with results - in terms of discretion - not qualitatively different from those that we notice in the case of balancing the interests of different stakeholders ([14]).

([12]) A related critique is that in this perspective the abuse of discretion by managers can be sanctioned only by *ex post* remedies, as legal actions for breach of fiduciary duties, but cannot be controlled *ex ante*: see Danilo Galletti, "Corporate governance e responsabilità sociale d'impresa", in *Scritti in onore di Vincenzo Buonocore* (Giuffré, Milano, 2005) Vol. III-2, 2621.

([13]) See Francesco Denozza, "Non-financial Disclosure between Shareholder Value and Socially Responsible Investing", in G Ferrarini and E Wymeersch (eds), *Investor Protection in Europe* (Oxford University Press 2006) 365.

([14]) In fact, the "old contractualists" recognised that a sole common interest of all shareholders does not exist and preferred to speak of a "group" of common interests defined in the contract by which the company has been founded; they recognized consequently that often exist contrasting alternative conduct – e.g. distribute or not distribute dividends- that may be both coherent with the shareholders common interest. On the "contractualistic" conception of the shareholders' interest see Pier Giusto Jaeger, *L'interesse sociale* (Giuffrè Editore, Milano,

A third reason is a historical reason, and concerns the appearance on the horizon of a request for social responsibility that does not operate from outside of the market - as is the case of the legislature or other organised institutions (trade unions, associations, etc..) - but from within the market itself.

It concerns the request for company responsibility advanced by consumers and investors. The development of this request may lead to a radical change in the context where an alternative between shareholder value and CSR is placed. Up to recent times the debate about the means to control firms' behaviour was tight in a straight alternative between companies left free to follow their natural tendency to maximise profits, with no external controls but the usual controls about their compliance with the law, and subjecting them to an ambiguous conditioning from outside entities (labour unions, local administrators, different lobby groups, and so on) open to easy insertion of very unwelcome political interference. The presence of a request - coming from civil society - that manages to be present on markets where the company offers its products, as well as the markets where it requests capital, creates a completely new ground for intervention.

In this context, the main public task could no longer be that of controlling the company's conduct directly, but that of encouraging and facilitating -by creating adequate institutional tools- the control of companies' behaviour by consumers and investors who are more sensitive towards themes of social responsibility.

4. Critique to "long-term coincidence" and "team production" theories.

1964). For recent contributions to the "contractualism-institutionalism" debate in Italy see Giorgio Oppo, "Le grandi opzioni della riforma e le società per azioni", in Rivista di diritto civile, 2003, 477; Gastone Cottino, "Contrattualismo e istituzionalismo (Variazioni sul tema da uno spunto di Giorgio Oppo", in Rivista delle società, 2005, 693; Vincenzo Buonocore, "Etica degli affari e impresa etica", in Giurisprudenza commerciale, 2004, I, 183.

The "long-term coincidence" theory and – especially – the "team production" theory undoubtedly have a more interesting vision of the interests at stake and the concept of the shareholder's interests that they advance seems more attractive than the narrow approach of the shareholders' value; the idea that shareholders (or at least some of them) do not necessarily belong to the "short-term rational investor" described by the supporters of the shareholders' value appears to be realistic, other than theoretically interesting.

These theories, however, encounter other significant problems, other than sharing some of the problems that we have outlined with regard to the theory of the shareholders' value, both in terms of internal coherence, and in terms of ability to produce their expected results.

The first of these problems relates to the definition of "long-term". Both theories, albeit in different perspectives, suggest that managers should not pursue the interest of shareholders to the short-term profitability of the firm at the detriment of other stakeholders, because this behaviour would prevent the maximisation of value of the firm properly conceived. Both theories, therefore, state a case for a long-term perspective in the management of the firm. The problem, however, is that neither theory is able to provide a meaningful definition of this concept, so it remains substantially undetermined. Each time managers choose a course of action that implies a sacrifice to an actual profit, the theory gives no clue to determine whether this sacrifice corresponds to the "true" interest of shareholders in the supposedly proper long-time perspective. We are left with a minus that is certain, and with a benefit that is completely undeterminable (even in an *ex post* analysis, as we shall see).

A second theoretical problem of the theory – and especially of the "team production" approach – resides in the transaction-cost analysis that supports the constructive part of the same theory ([15]). More precisely, we refer to the problem of "opportunism". According to the "team production" theory,

([15]) For a critique of the "team production" approach using arguments similar to those proposed in the text see Alan J Meese, "The Team Production Theory of Corporate Law: A Critical Assessment", 43 William & Mary L. Rev. 1629 (2002), <http://papers.ssrn.com/sol3/papers.cfm?abstract_id=373783>.

shareholders' opportunism may arise from their desire for short-term profitability. Essentially, due to a problem of coordination with the other stakeholders (or, in the long-term coincidence approach, to a lack of understanding of their real interests), shareholders may be induced to prefer an immediate profitability thus inevitably reducing the aggregate value of the firm. From this premise, it is deduced that, precisely because of the possibility that shareholders will behave opportunistically to the detriment of other stakeholders, it is important that managers are independent from shareholders and are not under their direct control. A question arises however: why does the theory only consider the opportunism of shareholders? It seems likely that at least certain stakeholders have the possibility to behave opportunistically because they have something to gain and because their position in relation to the firm puts them in the position to do so. For example, it is relatively easy to imagine that certain types of creditors would be in such a position. If we admit this possibility, than the transaction-cost analysis becomes more complex and the question of managerial discretion goes well beyond the problem of shareholders' opportunism. Managers should be provided with powers useful not only to prevent the opportunism of shareholders, but also to resist the opportunism of other stakeholders. What (think to the powers needed to resist the "opportunism" of a local Authority) seems frankly exorbitant.

From another point of view, the theory states that opportunistic behaviour is not a winning strategy in the long run and will be therefore discarded: since the interaction among all stakeholders in the firm is repeated over time, if shareholders act opportunistically, they will acquire a "bad" reputation and therefore the other stakeholders will reduce their investment in the firm thus reducing its aggregate value. Therefore, rational shareholders will not choose this strategy in the first place. This argument however relies on a critical assumption that does not appear to be very realistic and that is not theoretically demonstrable. The assumption is that opportunistic behaviour will always be sanctioned and that reputation mechanisms will always work. This is not necessarily true however. It may be the case that some stakeholders can be

exploited by opportunistic behaviour without any consequence, or – which is even more likely – with consequences that do not offset the benefits of the opportunistic behaviour. Some stakeholders are not in the position to react to opportunism or even to detect it; they may lack information, or coordination, or both. Stakeholders are not all in the same position towards the corporation; it is not obvious that reputation works where there are – as it is very likely to happen – different types of stakeholders with different interests. Some stakeholders, because they are better organized or because they have more negotiating power towards the corporation, may prefer to negotiate with shareholders for a solution that does not necessarily benefit other stakeholders. On the other hand, the reputation mechanism does not work as an on/off alternative but as a *continuum* of possible choices that reflect a different cost/benefit equilibrium. In any given situation, given the factual background, the potential "opportunist" is not confronted with a choice between good and bad reputation, but most of the times with a set of possible intermediate alternatives.

In the end, the point is – in our opinion – that the proposition that opportunistic behaviour is not a winning strategy cannot be presented as universally true, but is rather an empirical question. In other words, and more generally, there are reasons to doubt that cooperation with the other stakeholders that implies giving up immediate profits is always and necessarily in the best interests of shareholders, even if we admit that it is in the best interest of all stakeholders (including shareholders) as a whole: where there is room for profitable opportunism, it may be the case that one prefers a bigger slice of a smaller cake.

With regards to the problems of power within the corporation, the primary outcome of these conceptions revolves around a redefinition of the role of managers, designed not as trustees of shareholders (as in the shareholder value and in the old contractual conception), nor as interpreters of the superior interest of the corporation-institution (as in the traditional institutional

conception), but as mediators amongst the various categories of parties, who in various ways, provide their contribution to the performance of the company.

The managers - bound to operate as mediators - would therefore be prohibited to use opportunistic conduct, at the loss of each categories of stakeholders, with consequent greater trust by all in the stability of relations and greater availability of everyone to invest resources in the development of cooperation.

Apart from the considerations on its internal (in)coherence – which we have presented so far - the theory with managers acting as mediating hierarchs (so called "team production theory") can be assessed in terms of effectiveness (*de jure condito*) or on the project (*de jure condendo*). We shall examine the theory under the first perspective in this paragraph; a few thoughts on the second perspective shall be made in the next paragraph.

We believe that at least in Europe it would be quite difficult to consider a shareholder as any one of the many parties that in some way invest any resource in the company, and consequently, to attribute to today's managers of public corporations the role as intermediary, impartially concerned with the needs of all different categories of stakeholders. There is no doubt whatsoever that in all major European countries shareholders have the ultimate power to appoint and remove the corporation managers. Even in Germany, the co-determination system (*Mitbestimmung*) does not subvert this principle: even when workers have a number of representatives in the Supervisory Board (*Aufsichtsracht*) equal to shareholders, the latter have the power to appoint the President of the board, who has casting vote in case of parity ([16]).

In fact, even for this sole reason, shareholders cannot be placed on the same level as other stakeholders whose possibility to affect the choice of the managers is legally void and even in practice very limited.

([16]) See the German Codetermination Act of 1976 (*Mitbestimmungsgesetz*), article 29. According to article 27, the chairperson is to be elected by a two-third majority of all members of the supervisory board. If the necessary majority is not attainable, the chairperson is elected by the shareholders' representatives while the employees' representatives may only elect the vice-chairperson.

It should be added that in terms of responsibility it is difficult to imagine that a court might condemn a manager for abusing her role as intermediary and for conduct that benefits shareholders whilst damaging other stakeholders.

It could be conceivable that a judge restrains from condemning a manager who at times favoured a stakeholder different from a shareholder. But actually it is not conceivable that a manager could be condemned for using her power "too much" in favour of the shareholders' interests rather than in the interests of other stakeholders (we are of course talking about a manager who moves within his discretion and who is not violating any rule of law).

Overall, the general regulatory policy puts managers in a position where the complete fulfilment of the shareholders' interests protect them, with regards to the loss of their mandate, as well as their legal responsibility, whilst the fulfilment of the other stakeholders' interests- in cases in which they come in conflict with the fulfilment of the shareholders' interests - exposes them at best, to risks, and, at worst, to the certainty of negative consequences. This being the situation, not even a saint could be asked to maintain the impartial behaviour of a pure intermediary.

5. On the boundaries of the discretionary power of managers.

Summing up the main conclusions stemming from the previous analysis, if we assume that the interests of the shareholders may often be in irreconcilable conflict with that of the other stakeholders, the only way that seems open for satisfying the demands of CSR is that of compelling the shareholders (and their appointed agents) to limit the "wild" pursue of their own interests, by means of external constraints (as in the theory of the shareholder value) or even (as in the "old institutionalism") by imposing on managers a duty to pursue an interest (that of the firm as such) which does not coincide with that of the shareholders.

The theory of the team production and that of the long-term coincidence, both propose, albeit in different perspectives, a different view, in which the interests

of the shareholders and that of other stakeholders may be not so contrasting and conflicting as they are presented by the traditional theory of the shareholder value, and a wide area exists in which the interest of different stakeholders overlap or may even, from a certain viewpoint, be identical.

If one accepts this viewpoint, one is however confronted with other very difficult problems associated with the identification of the concrete solutions that in any given situation are able to obtain the best coordination of the interests of all stakeholders.

The problems arise from the fact that in both theories the possible coincidence depends on the acceptance of a peculiar perspective (the "long term" or the "social contract" perspective) whose ability to provide univocal concrete solutions (i.e. to indicate in every given situation a precise line of conduct able to obtain the best satisfaction of all involved interests) seems to be very scant. That is especially evident for the long-term perspective, in which just the parametric concept (that of "long term") is somewhat confusing (if it is interpreted literally, as an actual reference to the flowing of the time, difficult problems arise in defining the boarders of the short, the medium and the long term) and that may be confronted with an infinity of examples in which no intuitive (and, as it seems very often the case, neither reasoned) indication for a proper coordination of the conflicting interests can be inferred from the adoption of a long term perspective. But even the "social contract" perspective, that undoubtedly resorts to more refined conceptual tools, suffers from the same disease. In the end the consensus needed in order to stipulate a social contract (or in order to organize interactions as if a social contract had been stipulated) is a very complex one.

In conclusion, both theories maintain that a wide field exists in which the apparent conflict between shareholder and other stakeholder interests can be composed by decisions that, when evaluated in the perspective of a repeated game, are in the best interest of all stakeholders. But neither provides specific criteria for identifying *ex ante*, in any given situation, the right solution, let alone

the precise criteria which were needed in order to make someone accountable for having recklessly taken the wrong decision.

Besides other problems arise from the fact that an intermediary body, to be reliable, should be either totally disinterested or adequately representative of the various interests involved.

Both alternatives seem difficult to accomplish. Disinterested agents should be appointed by disinterested principals and their compensation should be independent from the immediate financial results achieved by the corporation, two innovations in corporate law that seem at present unrealistic. As to the second alternative (stakeholder interest represented in the board), it evokes "balkanised" boards of directors, a theatre of continuing skirmishes between contrasting and changing coalitions of small and quarrelsome potentates.

Lacking these innovations, the main consequences, at the level of the applicable legal rules, are the scant possibility of relying on the impartiality of managers coupled with the enormous difficulty of entrusting a court with the task of examining *ex post* the different factors which may affect the concrete consequences of a given choice, in order to establish whether a decision was taken in the exclusive interest of one stakeholder or was taken in the immediate interest of one stakeholder, but with the perspective of advantaging in the future all stakeholders, or was taken in the interest of one stakeholder but with the perspective of compensating the others in the future so to obtain on the whole a fair division of the surplus generated by the cooperation of all stakeholders. It seems that usually courts are not well positioned for collecting and evaluating *a posteriori* all the information needed for motivating this kind of judgments and it seems to us that in any case no relevant system exists in which courts are allowed to review *a posteriori* the decisions of the managers concerning the best way to pursue the corporation interests. From that premise, it follows that the final result of the theories that entrust the managers with the faculty or the duty of balancing the interests of the shareholders with that of other stakeholders is in fact an enormous increase of the discretionary power of the managers.

This point may be well illustrated by the case Shlensky v. Wrigley that we decided to use as an explanatory example. As we saw, in that case the plaintiff accuses the defendant of refusing to install night lights (which we assume to be in the immediate financial interest of the shareholders) and the defendant replies that the installation would harm the neighbourhood. According to our opinion, giving the managers the possibility of legitimately sacrificing the immediate financial interests of the shareholders inevitably amounts to increasing their discretionary power. On the one hand, it is evident that no court could impose a choice in favour of the (supposed) interests of the neighbourhood or condemn the managers for having decided in favour of trying to redress the financial situation of the corporation by installing the lights. On the other hand, if the interest to keep the neighbourhood from deteriorating is considered (as it was considered by the court) compatible with the long run interest of the corporation, the managers cannot be blamed for having decided against the financial interests of the shareholders and in favour of the interests of the "neighbourhood". The inevitable conclusion, is that, in practice, they can do what they want.

Lacking a deeper analysis of the different interests involved by the decision to install or not to install the lights and the possibility that a court will revise this analysis, the practical result is - and cannot be different from - an increase in the discretionary power of managers.

6. How to improve the possible consideration of the stakeholders' interest without increasing the managers' discretion.

To conclude, we believe that none of the current approaches to the question of CSR that we have grouped under the categories of "shareholders' value", "long-term coincidence" and "team production" is satisfactory both in terms of its internal coherence and with regard to its ability to provide an effective guidance to managers and a limitation to their discretionary power. More specifically, a major problem of all the three approaches is that they do not

provide precise criteria to individuate *ex ante* the right course of action for managers and therefore they must rely on *ex post* control by courts; *ex post* control, however, is not effective enough – for the above stated reasons – and therefore it is likely that none of the theories is able to reach its goal – that is, to control the discretionary power of managers so to ensure that the corporate interest (as qualified by each theory) is in fact correctly pursued.

Moreover, those theories (and namely the "long-term coincidence" and the "team production approach") that see managers as impartial trustees of all stakeholders rather than fiduciaries of shareholders do not seem realistic to the extent that they ignore the potential for opportunistic behaviour by managers induced by the short-term pressures coming from capital markets – an element of fact that seems impossible to deny and ignore.

We maintain that in the case in which there is such a great difficulty in defining the criteria to guide the content of the managers' decisions, it is better to shift the attention from the substance to the procedure. In the case of CSR, the procedure might be paramount in pursuing two important goals. The first is just that of identifying the decisions in which a conflict of interests may be present and the proper terms of such conflict. The second is that of subordinating the decision to a careful analysis which impartially evaluates the positions of all the stakeholders involved in the conflict.

The task of carefully analyzing the different possible solutions, their foreseeable consequences and especially their actual incidence on the interests of the different stakeholders is logically preliminary to any choice on the merit, i.e. on the interests that shall be protected and their hierarchy. We saw, however, that this analysis goes well beyond the competence of a court judging on the liability of the managers. The court can decide whether the goal that managers declare to pursue is a legitimate one and whether it appears to be in fact the goal really pursued. The courts are instead usually inhibited from deciding whether in the given circumstances it might be better to pursue one instead of another among the possible corporate goals. In our view this

analysis should be made *ex ante* by the managers and should be imposed by a procedural rule rather than by a substantial rule.

In this sense we can imagine at least two rules of best practice that in our view could improve the quality of the decisions in CSR matters.

1. The first rule should impose procedures of organized contacts between the board and the relevant stakeholders of the firm. This would permit managers to collect information concerning the instances of the various groups of stakeholders and to assess the interests at stake and the areas of potential conflicts between stakeholders and shareholders and possibly within the stakeholders themselves.
2. The second and most important rule should establish that the board must separately examine and motivate every decision contrary to the immediate financial interest of the shareholders.

It might seem paradoxical that in order to favour corporate social responsibility we propose to impose an obligation to justify decisions that are contrary to the interest of shareholders (the inverse would appear the logical rule). However, we believe that this rule could reach three important goals:

1. Firstly, it would lead to public disclosure of the corporate decisions that benefit stakeholders other than the shareholders of the firm. This could produce several positive results. To begin with, it could facilitate the functioning of reputation and market mechanisms that can push towards the inclusion of stakeholders' interests within corporate action. Secondly, disclosure would make possible an effective assessment of the corporate decisions in favour of stakeholders and the evaluation of the real impact of the same decisions on the different stakeholders and on shareholders. This, in turn, would make it possible to verify the content of corporate action in favour of stakeholders and the effective

application of sustainability projects, much more than the usual reports voluntarily published by firms that rarely contain verifiable data ([17]).

2. Secondly, the duty to instruct and motivate decisions affecting the immediate financial results of the firm for its shareholders could create at least a certain limitation to the discretionary power of managers, not on the merits, but through a procedural constraint. In fact, in case of non-compliance with the motivation procedure, managers would be prevented from providing *ex post* justification for a particular decision contrary to the immediate financial interests of shareholders, by motivating it on the basis of the pursuit of the interest of stakeholders.

3. Thirdly, but not least, the obligation to motivate this type of decision could have a positive influence on the perception by shareholders of the usefulness for the firm to pursue interests other than immediate financial profits; to the extent that managers are able to make a convincing case that the sacrifice of the immediate profitability for shareholders in a particular situation may be in the interest of the firm, this could in perspective contribute to the diffusion of a perception of the shareholders' interests not narrowly focused on the short-term profitability of the firm.

Going back to the example of the night lights, according to our approach the board should not have limited himself to credit the "protection of the neighbourhood" thesis, but should have asked in what sense the decision not to install the lights could have been considered as in the long run interest of the corporation, how the corporation would have been able to react in case the

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([17]) See Eddy Wymeersch, "The Corporate Governance 'Codes of Conduct' between state and private law", Financial Law Institute – Working Paper Series, November 2007 <http://www.law.UGent.be/fli>, who underlines the weaknesses in the enforcement of codes of conduct and calls for stronger intervention while preserving the voluntary nature of the codes. See also Serenella Rossi, "Luci e ombre dei codici etici d'impresa", paper presented at the conference "Le fonti private del diritto commerciale", Catania, 20-21 September 2007, forthcoming in Rivista del Diritto Societario (2008).

lights have been installed by all competitors, what the corporation could have done in order to assess the actual preferences of the inhabitants of the neighbourhood and so forth.

In our approach, the lack of motivation for the decision or a patently unreasonable motivation might provide the courts with sound arguments for holding managers responsible for the harm possibly caused to the company.